About the author

Michiya Matsukawa is a member of the Group of Thirty. Since 1980 he has been Senior Advisor to the President of the Nikko Securities Company and Chairman of the Institute of the Nikko Research Centre. From 1947 to 1980 he served in the Japanese Ministry of Finance. He was Vice Minister for International Affairs between 1976 and 1978, and Special Advisor to the Minister of Finance from 1978 to 1980.

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The Japanese Trade Surplus And Capital Outflow

Michiya Matsukawa

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I. Introduction

One of the most important economic issues in the world today is the huge imbalance of trade between key countries, which has its counterpart in large scale capital flows across national boundaries. These imbalances have increased since 1983, and there have so far been few indications which would suggest an early reduction, though it is hard to believe that they are sustainable. Every effort has to be made to prevent the further worsening of the situation in order to pursue the sound development of the world economy.

At present, the spotlight is on Japan. Her huge trade surplus and enormous capital outflow are causing worldwide frustrations, and she is asked to share responsibility for stimulating the global economy. How long will Japan's trade surplus continue? When will Japan cease to export her capital overseas? How soon and to what degree will these changes occur? These are matters of common concern all over the world.

For instance, the savings rate in Japan is a matter of keen interest. It is from time to time advanced by some economists as the cause of the trade surplus of Japan. Accordingly the Japanese authorities are requested, explicitly or implicitly, to adopt policy measures to discourage the high rate of savings. At the same time, however, Japan is regarded as a major source of capital for those countries where domestic savings are too small to meet the needs of necessary investment. If it were not for the capital coming from Japan, interest rates in the world as a whole might have been much higher than they now are. It is claimed, for instance, that rates in the United States would definitely have been higher, and the debt situation of many developing countries would have been in much worse shape than at present.

Thus it will be useful briefly to sketch the present picture of Japanese foreign trade and its surplus, the major features of change in recent years and the future perspective. This will be followed by a discussion of the changes in the capital transactions of Japan. Emphasis will be placed upon the capital outflow from Japan in recent years and prospects for the next few years.

II. Japan's Trade Surplus

A. Recent Developments

The trade balance of Japan was in deficit every year after the Second World War until 1963, and the current balance was also in deficit until 1965. Japan had to import capital to finance the deficits in these years. Since then, both categories were mostly in surplus but fell into deficit three times; namely, in the years after the Nixon Shock (1967), the First Oil Shock (1973 to 1975) and the Second Oil Shock (1979 to 1980).

As shown in Table 1, it was only in the last three years that Japan's trade surplus started rising very fast. It was $18 billion in 1982, $31 billion in 1983, $44 billion in 1984 and reached $56 billion in 1985. Correspondingly, Japan's current account surplus was $6 billion in 1982, $20 billion in 1983, $35 billion in 1984, and it rose to $49 billion in 1985. The ratio of the trade surplus to the GNP of Japan also rose sharply in these years; it was 1.7% in 1982, 2.7% in 1983, 3.4% in 1984 and 4.2% in 1985.

A distinctive feature in the growth pattern of the Japanese trade surplus in the past three years was that it mostly reflected an increase in the country's bilateral surplus with the United States. Japan's trade surplus with the United States (Customs Clearance Basis) was $12 billion in 1982 when the global surplus was $7 billion. It rose to $18 billion in 1983 as against $20 billion for the global surplus, $33 billion in 1984 as against $33 billion, and reached $39 billion in 1985 as against $46 billion. Table 2 shows that while the surplus with the United States grew and the trade surplus became very large, the balance with the other countries as a whole did not change much, neither rising nor declining.

B. Industrial Structure

The basic cause of the trade surplus of Japan is now believed to be the export-oriented nature of its industrial growth. When the world economy grows, Japan's exports grow faster than its imports, thus leaving its trade surplus larger. However, this was not necessarily true in earlier years.

The export-oriented structure of the Japanese economy has a historical background. In the early post-war period of the 1940's, industrial policy emphasis was placed in Japan on building up strong basic industries, and securing enough coal, steel and electric power. There was a strong national consensus at that time that Japan would not be able to purchase foods and raw materials to survive without strong and competitive manufacturing industries. Decades later when untiring efforts by the Japanese, both in the Government and the private sector, succeeded in building up strong manufacturing industries, Japan's trade partners were

surprised by Japan's rapid development and much impressed by the unique nature of its consensual society. They nicknamed Japan 'Japan Inc'.

The focus of development in the latter half of the 1950's was on building up the heavy industries and the chemical industries. A number of high capacity steel mills, ship-building yards and petro-refinery plants were constructed. Then came a phase in which various modern industries were securely founded, such as automobiles, electronics and the computer industries. Meanwhile, some specific technologies attracted nationwide attention, since they were urgently needed under the then existing conditions. They included anti-pollution, energy-saving and labor-saving technologies.

Throughout the four decades of the post-war period, the national consensus that Japan must export manufactured goods, so as to be able to import foods and raw materials to survive, became firmer. The experiences of the Nixon Shock and two Oil Shocks strengthened this consensus. It was only in recent years that the Japanese people recognised that excessively strong export capability and extremely low import propensity could jeopardise the economic security of Japan.

The technological advance developed in coping with the Oil Shocks contributed to a smooth shift from the traditional industries (of the heavy, the thick, the long and the large) to the modern high-tech industries (of the light, the thin, the short and the small), and has made Japanese manufacturing industries more competitive in the global market and thus more export-prone. The changes in the structure of Japanese trade since 1965 are indicated in Table 3.

The size of Japan's trade surplus has now reached a level high enough to cause frustrations and anxieties all over the world. Among the Japanese themselves, the validity of their long-standing guiding principle of 'Build up a strong manufacturing industry to survive' has been reconsidered, and an alternative framework was set out in April, 1986, in the Report of the 'Advisory Group on Economic Structural Adjustment for International Harmony' which was chaired by Mr. Haruo Maekawa, former Governor of the Bank of Japan.

This report, commonly referred to as the Maekawa Report, contains recommendations for policies designed to:

1) expand domestic demand,

2) move towards an internationally harmonious industrial structure,

3) improve access to Japanese markets and encourage the import of manufactured goods,

4) stabilise exchange rates; liberalise and internationalise financial and capital markets,

Table 1

Japan's International Balance of Payments (IMF Definition)
(US $ million)

	Exports	Imports	Trade Balance	Current Balance	Long term Capital Balance	Basic Balance	Gold & Foreign Exchange Reserves (*)	Ratio of Trade Balance to GNP (%)
1965	8,332	6,431	1,901	932	▲ 415	517	2,107	2.1
1970	18,969	15,006	3,963	1,970	▲ 1,591	379	4,399	1.9
1975	54,734	49,706	5,028	▲ 682	▲ 272	▲ 954	12,815	0.9
1980	126,736	124,611	2,125	▲ 10,746	2,394	▲ 8,352	25,232	0.2
1981	149,522	129,555	19,967	4,770	▲ 6,449	▲ 1,679	28,403	1.7
1982	137,663	119,584	18,079	6,850	▲ 14,969	▲ 8,119	23,262	1.7
1983	145,468	114,014	31,454	20,799	▲ 17,700	3,099	24,496	2.7
1984	168,290	124,033	44,257	35,003	▲ 49,651	▲ 14,648	26,313	3.4
1985	174,015	118,029	55,986	49,169	▲ 64,542	▲ 15,373	26,510	4.2
1986 (Jan/Oct) (p)	169,828	96,056	73,772	68,236	▲102,775	▲ 34,539	41,676	—

(*) End of year or month.
▲ Indicates deficit.
(p) Provisional figures.

Source: The Bank of Japan, "Balance of Payments of Japan"

Table 2

Japan's Trade Balance* by Area

	1982					1985					Changes in Trade Balance between 1982 & 1985
	Exports	(Share) Percent	Imports	(Share) Percent	Trade Balance	Exports	(Share) Percent	Imports	(Share) Percent	Trade Balance	
Developed Countries	68.0	(49.0)	48.4	(36.7)	19.6	102.5	(58.3)	53.1	(41.0)	49.4	+29.8
U.S.A.	36.3	(26.2)	24.2	(18.3)	12.1	65.3	(37.2)	25.8	(19.9)	39.5	+27.4
Western Europe	21.6	(15.6)	10.1	(7.7)	11.5	25.2	(14.4)	12.4	(9.6)	12.8	+ 1.3
Developing Countries	62.4	(45.0)	76.1	(57.7)	▲ 13.7	57.0	(32.5)	67.9	(52.4)	▲ 10.9	+ 2.8
South East Asia	31.8	(22.9)	30.0	(22.7)	1.8	33.2	(18.9)	30.3	(23.4)	3.0	+ 1.2
Middle East	16.9	(12.2)	37.8	(28.7)	▲ 20.8	12.2	(6.9)	29.9	(23.1)	▲ 17.8	+ 3.0
Latin America	9.1	(6.6)	6.3	(4.8)	2.8	8.5	(4.8)	6.2	(4.8)	2.3	− 0.5
Africa	4.2	(3.0)	1.6	(1.2)	2.6	2.5	(1.3)	1.1	(0.8)	1.4	− 1.2
Communist Bloc	8.4	(6.1)	7.4	(5.6)	1.0	16.2	(9.2)	8.5	(6.5)	7.7	+ 6.7
Total	138.8	(100.0)	131.9	(100.0)	6.9	175.6	(100.0)	129.5	(100.0)	46.1	+39.2

* Customs Clearance Basis, FOB prices for exports and CIF prices for imports.

Source: Ministry of Finance, "The Summary Report on Trade of Japan"

Table 3

Japan's International Trade Structure (Percentage Composition)

Exports	1965	1975	1985
Foodstuffs	4.1	1.4	0.8
Textiles	18.7	6.7	3.6
Chemicals	6.5	7.0	4.4
Non metallic Products	3.1	1.3	1.2
Metal Products	20.3	22.5	10.5
(Iron & Steel Products)	(15.3)	(18.3)	(7.7)
Machinery & Equipment	35.2	53.8	71.8
(Ships)	(8.8)	(10.8)	(3.4)
(Motor Vehicles)	(2.8)	(11.1)	(19.6)
(Hi-Tech Products) (*)		(8.8)	(19.4)
(Others)	(23.6)	(23.1)	(29.4)
Others	12.1	7.4	7.7
Total	100.0	100.0	100.0

Imports	1965	1975	1985
Foodstuffs	18.0	15.2	12.0
Raw Materials & Fuels	59.4	64.5	57.0
(Textile Materials)	(10.4)	(2.6)	(1.7)
(Metal Ores & Scrap)	(12.5)	(7.6)	(4.8)
(Coal)	(3.3)	(6.0	(4.0)
(Crude Oil)	(12.8)	(33.9)	(26.7)
(Petroleum Products)	(3.5)	(2.3)	(4.6)
Chemicals	5.0	3.6	6.2
Machinery & Equipment	8.7	7.4	9.6
Others	8.9	9.3	15.2
Total	100.0	100.0	100.0

(*) Covers telecommunications equipment, integrated circuits, scientific & optical equipment, and office machinery (including computers) etc.

Source: Ministry of Finance, "The Summary Report on Trade of Japan"

5) promote international economic assistance, and

6) manage fiscal and monetary policy flexibly.

It is not an easy task to implement the recommendations of the Maekawa Report because of the political difficulties involved. The report touches upon the overhaul and adjustment of the industrial structure, without which the export-prone nature of the Japanese industries will not be changed, but which is certain to call for overall reshuffling and realignment of the labor force. Continuing efforts by the Government and an unprecedented degree of support by the Members of the Diet (Parliament) are strongly advocated not only for the benefit of Japan's trade partners but also for Japan herself.

C. Trade Frictions

Trade frictions between Japan and her major trade partners are nothing new. As early as the late 1960's, there were bilateral trade negotiations on possible import controls by the United States and/or export restrictions by Japan. These negotiations covered a variety of commodities, from textile products to TV sets, from steel to automobiles. In most cases, solutions were sought by setting the maximum amount of each commodity to be exported to the US market. In recent years, however, trade frictions have become a matter of wider coverage and continuous negotiations. There are clear changes in the nature of trade frictions.

(a) The trade negotiations in the past were aimed at controlling the flow of specific commodities flooding into the market of the importing country. The negotiations related to single commodities. Now the negotiations have started to cover a number of different commodities at the same time and are aimed at the overall trade balance. Thus trade negotiations have become the focus of wider frictions and/or more difficult political and social issues.

(b) Trade friction used to be a matter of a one-way flow of commodities; an importing country made complaints against the excessive export of certain goods by another country. GATT negotiations are generally conducted within a multilateral framework, with agreement requiring concessions by all parties. This is usually not the case for trade negotiations outside of the forum of the GATT. In recent years negotiations to reduce trade frictions have tended to be carried out in a spirit of bilateralism with both sides making requests of and raising complaints against the other.

(c) Trade negotiations used to take place on the basis of damage to the importing country only after there had been excessive amounts of exports of certain commodities. Recently, negotiations have tended to be initiated before damage is done in the importing country. When it becomes widely

recognised that the increased import of certain commodities will probably cause severe damage to the importing country, then the exporting country is requested to start negotiations on the trade of those commodities. This change has caused trade negotiations to be increasingly influenced by political factors.

(d) Trade negotiations used to cover customs tariffs, import restrictions, export controls on volume and/or the unit price, all of which were connected with the flow of commodities across national boundaries. However, in recent years, negotiations have tended to go beyond trade transactions into purely domestic matters and to involve changes in domestic policies, including safety standards, tax policy, budget policy, monetary policy and the like.

The foreign exchange rate has very frequently become an important component of the trade friction problem. A country which has a large trade surplus, or is rapidly increasing her surplus, has been criticised for having kept the exchange rate too cheap for the sound development of international trade. The exchange rate itself has become more influenced by the flow of capital, not of commodities, and is not necessarily linked with the trade balance. Moreover, no effective way to stabilise the exchange rate, as it was under the Bretton Woods system, has been found. Even when the exchange rate is moving towards an equilibrium level for trade, it now requires a longer time for rate changes to be fully reflected in the trade balance.

Against this background, frustrations over trade now generate much discussion between a growing number of countries. Among the leading economic powers, for instance, regular talks are being held to promote better trade balances among themselves, both through control over the trade in specific commodities and through a convergence of their macro-economic policies.

Despite these continuous efforts, it remains the case that those measures which would prove effective to restore the balance of trade are mostly unpopular in domestic political circles and are difficult to adopt, since they are certain to ask for sacrifices from some sector of the country. The wider and deeper the trade frictions grow, the longer the time necessary for a solution.

D. Impact of Yen Appreciation

The recent rapid appreciation of the yen is having a strong impact upon the foreign trade of Japan. However, the dearer yen has not yet much affected the trade balance. This is because the adverse J-curve effects of the exchange rate turnaround are now governing Japan's trade balance, though the dearer yen will soon cause a movement towards equilibrium.

There is a good precedent in the case of the yen appreciation of 1977-78, when the yen-dollar rate rose from about Y285 to Y180 within two years. In the last stage of this rise of the yen, there took place the Second Oil Shock which suddenly made the yen cheaper. Nevertheless the experience from early 1977 to October 1978, as shown in Table 4, gives us some hints concerning the future pattern of Japan's trade following the yen appreciation.

In calculating the effect of exchange rate changes economists often assume that the prices of imported goods will be changed proportionately to the changes in the exchange rate. However, this is not necessarily what happens in the real world. As a matter of fact, the effect of the exchange rate changes upon trade is largely dependent on the extent to which the sale prices of exported goods are changed in response to the appreciation. In the present case, it is dependent upon how much Japanese exporters increase their selling prices to the importers or to the end buyers. The exporter determines the price according to the costs involved, but he also takes into consideration his strength in relation to the buyers in the market, and also his relative competitiveness with other exporters.

There are significant differences in the market conditions between now and the 1977-78 period. Firstly, the basic economic trend was inflationary in the 1977-78 period, especially in the United States, and it was easier for Japanese exporters to increase the dollar prices of their products to keep pace with the yen's appreciation, if not always to the full extent. Now prices are not rising and exporters are worrying a great deal about the possibility of a sharp decline in their sales overseas if their selling prices rise as fast as the yen rate moves upwards.

There are no reliable overall statistics available, but the dollar prices of imported Japanese goods were increased in the 1977-78 period by as much as 80% of the yen rate changes. But in the past year, selling prices in dollars have not changed much despite the yen appreciation, and exporters are believed to be squeezing their profits rather than taking the risk of losing their export market by making prices too high.

Secondly, the general economic condition of Japan is not very buoyant, so that many manufacturers cannot easily make up for lost export demand in the domestic market. The competition among Japanese manufacturers themselves is very strong in almost every field, including automobiles, electronics products and computer chips, all favorite export goods a year ago.

In addition, some newly industrialised countries, especially South Korea and Taiwan, are now competing in export markets with the advantage of favorable wage rates and, in many cases, favorable customs treatment by importing countries. Seven years ago those newly industri-

Table 4

J-curve Effects of Yen Appreciation (Index with base period of 100)

Recent Experience (Jan.-Mar. 1985-100)

	Yen Rate		Exports (in dollar terms)			Imports (in dollar terms)		
	Yen/$	(Index)	Value	Quantity	Unit Value	Value	Quantity	Unit Value
Jan.-Mar. '85	258	(100.0)	100.0	100.0	100.0	100.0	100.0	100.0
Apr.-June	251	(102.8)	104.9	102.1	102.7	102.3	102.7	99.6
July-Sept.	239	(107.9)	105.8	102.3	103.4	101.6	102.0	99.6
Oct.-Dec.	207	(124.6)	115.2	103.5	111.3	101.8	102.2	99.8
Jan.-Mar. '86	188	(137.2)	118.3	100.3	117.9	101.8	103.7	98.2
Apr.-June	170	(151.8)	127.2	101.1	125.8	100.9	120.6	83.7
July-Sept.	156	(165.3)	132.0	102.0	129.4	98.1	121.2	80.9

Previous Experience (Jan.-Mar. 1977-100)

	Yen Rate		Exports (in dollar terms)			Imports (in dollar terms)		
	Yen/$	(Index)	Value	Quantity	Unit Value	Value	Quantity	Unit Value
Jan.-Mar. '77	286	(100.0)	100.0	100.0	100.0	100.0	100.0	100.0
Apr.-June	275	(104.0)	104.5	102.6	101.9	101.2	97.9	103.4
July-Sept.	266	(107.5)	106.8	102.6	104.1	101.3	97.1	104.3
Oct.-Dec.	247	(115.8)	112.9	103.0	109.6	102.0	97.8	104.3
Jan.-Mar. '78	238	(120.2)	122.3	106.2	115.2	104.9	100.1	104.8
Apr.-June	221	(129.4)	126.4	98.6	128.3	108.9	102.2	106.6
July-Sept.	193	(148.2)	131.7	98.4	133.8	114.9	104.6	109.8
Oct.-Dec.	190	(150.5)	134.1	97.9	137.0	124.5	109.1	114.1
Jan.-Mar. '79	201	(142.3)	130.2	95.0	137.0	134.6	114.2	117.9
Apr.-June	218	(131.2)	131.8	98.5	133.8	146.6	115.3	127.2

Source: Ministry of Finance, "The Summary Report on Trade of Japan"

alised countries were not strong competitors for Japanese exporters, except in textiles and other light industrial products. This is no longer true. They are very strong competitors even in such products as steel, ships, automobiles, VTR's and computer chips. Japanese exporters are, therefore, extremely reluctant to raise their selling prices because of anxiety over the possible loss of export markets.

Under these circumstances, the short-term strategies for Japanese exporters are (a) to raise the dollar selling prices within a relatively small range so as not to lose much of their market share, (b) to streamline their production lines further and cut costs wherever possible, and, (c) to squeeze their profit, if that cannot be avoided. As longer-term strategies, many export businesses are examining the possibility of obtaining semi-finished parts and/or materials from countries where exchange rates are more favorable, or of moving production into foreign countries through direct investments.

Thus it will take a little longer than in the past before the adverse J-curve effects work through, and changes in the yen rate are fully reflected in the trade balance of Japan. Meanwhile the prolonged adverse J-curve effects continue to delay desirable changes in the trade balance, as recent statistics on foreign trade show clearly.

III. Capital Outflow From Japan

A. Recent Developments

In the early post-war period, Japan was a net capital importer from the outside world. It was in the latter half of the 1960's that Japan became a net capital exporter to foreign countries, having started to enjoy surpluses in its current account. However, in the 1960's and 1970's, there were strict controls by the Government over foreign exchange transactions, especially over international capital transactions. Capital outflows in those years consisted mainly of trade-related finance, economic assistance and direct investments (as shown in Table 5).

Since the beginning of the 1980's, as foreign exchange controls were gradually relaxed, investments into foreign securities became very large and increased rapidly year after year. This triggered a huge capital outflow from Japan.

Broken down geographically, the capital outflow from Japan in recent years was, as shown in Table 6, mostly directed toward the United States and the European Community countries. The underlying reasons relate, of course, to risks and yields. As outflows have grown, an increasing proportion has been invested in securities. Such flows have always been towards markets where risks were low and yields were high. In recent years

when outflows were rising to huge amounts, another factor was added; that is the size of the market. There are now more and more investments in extremely large lots, some being as large as the equivalent of several hundred million dollars. Accordingly, the capacity of the market to absorb such transactions, more simply the size of the market, is now becoming an important factor in selecting where to go.

For instance, out of a total gross capital outflow in 1985 of $81.8 billion, $31.6 billion (about 38.6%) were invested in US securities, and $18.5 billion (about 22.6%) into European Community securities. The size of those investments is reportedly growing even larger.

Government control over investments in foreign financial securities by the residents of Japan has gradually been liberalised since the 1970's. But it is only since a substantial degree of liberalisation was agreed between Japan and the United States in 1983 that these investments have become really active. The amount of securities investments (net) was a little below the $10 billion level in 1981 and 1982 but rose rapidly in 1983 through 1985, almost doubling its amount year after year and coming very close to $60 billion in 1985.

The trend of increasing securities investments is continuing in 1986 and the total amount (net) for the first six months rose to $44 billion or about 81% of the annual total amount in the preceding year. These investments are still heavily concentrated in bonds, with $42 billion going into bonds as compared with $2 billion into stocks, though the latter was just starting to rise rapidly and this $2 billion level was a record high.

The cumulative total of foreign bonds purchased by Japanese investors was $166 billion as of the end of June 1986. These bonds are now traded in the over-the-counter bond market in Tokyo. The total turnover of foreign bonds in the Tokyo market was $54 billion in 1984, $176 billion in 1985. Subsequently, the turn-over more than doubled at an annual rate, reaching $208 billion in the first six months of 1986.

At the same time, purchases of newly floated 'samurai bonds'* are also steadily increasing, though at a somewhat slower pace. The multinational financing institutions, such as IBRD, ADB, IDB and European Investment Bank, are increasing their bond issues, as are the developing countries. Issuers from developed countries are, however, gradually decreasing their share in the samurai bond market. The latest development was the introduction of the 'shogun bond'**, the amounts of which still remain relatively small ($930 million for eight issues in 1985).

Loans showed a steady increase in the latter half of the 1970's, mostly

* Samurai bonds are yen-denominated bonds floated in the Tokyo market by non-residents.
** Shogun bonds are foreign-currency-denominated bonds floated in the Tokyo market by non-residents.

Table 5

Composition of Long Term Capital Flows
(US $ million)

	Net Balance	Assets Total	Assets Direct Investments	Assets Trade Credits	Assets Loans	Assets Investments in Securities	Liabilities Total	Liabilities Investments in Securities	Reference: Current Balance
1965	▲ 415	446	77	243	115	0	31	11	932
1970	▲ 1,591	2,031	355	787	628	62	440	296	1,970
1975	▲ 272	3,392	1,763	29	1,295	24	3,120	2,753	▲ 682
1980	2,394	10,817	2,385	717	2,553	3,753	13,141	13,113	▲ 10,746
1981	▲ 6,449	22,809	4,894	2,731	5,083	8,777	13,137	13,220	4,770
1982	▲ 14,969	27,418	4,540	3,239	7,902	9,743	12,449	11,860	6,850
1983	▲ 17,700	32,459	3,612	2,589	8,425	16,024	14,759	14,148	20,799
1984	▲ 49,651	56,775	5,965	4,937	11,922	30,795	7,124	7,194	35,003
1985	▲ 64,542	81,815	6,452	2,817	10,427	59,773	17,273	16,741	49,169
1986 (Jan./Oct.) (p)	▲ 102,775	104,806	9,734	1,851	6,217	82,908	2,031	2,011	68,236

▲ Indicates deficit.
(p) Provisional figures.

Source: The Bank of Japan, "Balance of Payments of Japan"

Table 6

Capital Outflow by Area and Purpose
(US $ million)

	Year	Total	Direct Investment	Trade Credit	Loans	Investment in Securities	Other
U.S.A.	1980	▲ 309	833	▲ 26	281	▲ 1,609	212
	1985	35,384	2,557	588	702	31,599	▲ 62
EC	1980	2,402	262	▲ 13	12	2,035	106
Countries	1985	21,444	1,534	472	774	18,471	193
OECD Countries	1980	2,875	146	▲ 36	46	2,713	6
excl. US & EC	1985	8,514	420	793	2,165	5,122	14
Communist	1980	530	3	206	321	—	—
Bloc	1985	1,320	58	▲ 521	1,086	695	2
Other	1980	4,125	1,141	586	1,922	428	48
Countries	1985	9,227	1,883	1,485	4,843	416	600
International	1980	1,194	—	—	▲ 29	186	1,037
Institutions	1985	3,988	—	—	857	2,248	883
World	1980	10,817	2,385	717	2,553	3,753	1,409
	1985	81,815	6,452	2,817	10,427	59,773	2,346

▲ Indicates inflow to Japan.

Source: The Bank of Japan, "Balance of Payments of Japan"

to developing countries and the multinational financing institutions (see Table 7). However, the environment for raising funds had worsened in the Euromoney market, and loan risks had increased as the indebtedness of many developing countries rose rapidly to levels which became too high. The tempo of the increase was, for a time, substantially retarded. In the past three years, however, loans to developed countries, and yen-denominated loans, have started rising rapidly again. The total outstanding amount of these loans (including sort-term loans) increased from $64 billion at the end of 1980, to $170 billion at the end of 1985. Out of this total, yen-denominated loans amounted to $9 billion in 1980, and subsequently increased to $35 million within five years, reflecting the recent internationalisation of the yen and the desire of the lenders to avoid exchange risks in the volatile market.

Table 7

Outstanding Medium- and Long-term Loan Balances*

	In Foreign Currencies (US $ bn)			In Japanese Currency (¥ bn)		
	1983	1984	1985	1983	1984	1985
International Institutions	0.9	1.0	0.9	1,230	1,581	1,861
OECD Countries	22.9	25.9	29.7	1,311	2,309	3,227
Eastern Europe	3.3	3.5	5.0	392	400	575
Latin America	21.8	24.9	25.3	494	852	1,226
Asia	7.3	8.5	9.4	625	913	1,449
Middle East	0.3	0.4	0.5	29	22	21
Africa	1.9	2.0	2.1	409	397	478
Others	0.1	0.1	0.1	1	2	6
Total	58.6	66.4	73.1	4,491	6,476	8,842

* End-year data.

Source: Ministry of Finance, "Annual Report by International Monetary Bureau"

Another area where Japanese capital outflow has been very active is direct investment. This activity has been stimulated in the past several years by rapid developments in the globalisation of business and the internationalisation of financial activity on the one hand, and by the gradual build-up of protectionist movements in many countries on the other. Many Japanese businesses are making a serious effort to deploy their office networks worldwide in order to carry out their business on a more internationalised basis. Some others are moving their production plants from Japan to the countries which once imported their products. The object is to decrease exports which are already subject to import restrictions or which seem likely to give rise to trade frictions sooner or later. In recent years, the areas where Japanese direct investments rose most

were automobiles, electronics and finance; and an increasing share of these were directed to the United States and European countries.

As a result of those increases in Japanese overseas investment, the balance between the external assets and liabilities of Japan has improved as shown in Table 8. At the end of 1985, total overseas assets held by the Japanese was $437.7 billion, 7.5 times as much as ten years ago. With total overseas liabilities of $307.9 billion, net asset holdings were $129.8 billion, as compared with only $7 billion ten years ago. What is remarkable is the change of the net position of the private sector which moved from a net liability position of $10.6 billion at the end of 1975 to a net asset position of $104.5 billion ten years later.

This may mean that since the end of 1985 Japan has become the largest creditor country, having surpassed the United Kingdom and Saudi Arabia. However, Japan may still be behind the United States and the United Kingdom in total gross holdings of overseas assets. Among the types of assets which have increased most in recent years, financial securities have grown the fastest.

B. Background to Capital Outflow

1) Abundant Liquidity and High Savings

According to the school of thought which believes in the important role played by the balance between investment and saving, an excess of savings has been the underlying cause of Japan's huge trade surplus and capital outflow. A survey by the Bank of Japan shows that savings by households as a percentage of GNP has been decreasing continuously in recent years, but dissaving by the corporate and the public sectors has been declining even faster. The outcome has been an increased surplus in overall domestic savings.

Whereas the budget deficits in the United States remain far too large to be financed by the savings of the private sectors in that country, the savings by the household sector in Japan remain too large to be fully utilised by the investment of the corporate sector (which is relatively subdued) and by the budget deficits of the Government.

Even though the Japanese Government has decided to relax its austere budget policy and to give a fiscal stimulus to its faltering economy, it may be difficult dramatically to decrease the imbalance between domestic saving and investment within a short period. Cautious preparation for the ageing of society keeps household savings relatively high. Moreover, the prospects for continuing trade frictions and the doubts about the exchange rate restrain investment by corporations. Thus savings will remain higher than investment in Japan, and the balance will continue to seek investment outlets in foreign countries.

Table 8

Japanese External Assets and Liabilities vis a vis Non-residents*
(US $ billion)

Assets	1975	1985	1985 1975
Long term	32.4	301.3	(9.3)
Private Sector	24.5	264.5	(10.8)
Direct Investments	8.3	44.0	(5.3)
Trade Credits on Exports	6.8	23.6	(3.5)
Loans Extended	5.0	46.9	(9.4)
Securities Investments	4.1	145.7	(35.5)
Government Sector	7.8	36.8	(4.7)
Trade Credits on Exports	0.3	1.1	(3.7)
Loans Extended	5.5	23.3	(4.2)
Short term	26.0	136.4	(5.2)
Private Sector	13.2	108.8	(8.2)
Monetary Movements	12.9	99.7	(7.7)
Government Sector	12.8	27.7	(2.2)
Total Assets	58.3	437.7	(7.5)

Liabilities	1975	1985	1985 1975
Long term	13.6	122.3	(9.0)
Private Sector	11.9	91.8	(7.7)
Direct Investments	2.1	4.7	(2.2)
Trade Credits on Imports	0.1	0.1	(1.0)
Loans Received	1.7	1.2	(0.7)
Securities Investments	6.0	84.8	(14.1)
Government Sector	1.7	30.6	(18.0)
Loans Received	0.4	0.1	(0.3)
Securities Investments	0.2	30.5	(152.5)
Short term	37.7	185.6	(4.9)
Private Sector	36.4	177.0	(4.9)
Monetary Movements	26.4	161.0	(6.1)
Government Sector	1.3	8.6	(6.6)
Monetary Movements	0.7	4.6	(6.6)
Total Liabilities	51.3	307.9	(6.0)
Net Assets:			
Private Sector	▲10.6	104.5	(—)
Government Sector	17.6	25.4	(1.4)
Total	7.0	129.8	(18.5)

* End-year data.

Source: Ministry of Finance

2) Globalisation of Financial Markets

Rapid developments in computers and communications equipment have made it possible to deal with an extremely large number of transactions within a short period, and to manage highly complicated and sophisticated types of financial transactions linking together all the world's financial markets. Without modern office automation equipment, administrative burdens would no doubt have limited the massive increase in financial transactions in past years. Without the rapid developments in world-wide communications, especially communications via satellites, the movement of capital could not have developed on the international scale we see today. The new technology has also facilitated the emergence of complex combinations of various types of financial arrangements.

The rapid computerisation of today requires an extremely large outlay of capital, which smaller financial firms are not necessarily able to make. Stronger firms, however, are becoming more competitive, supported by computers and the introduction of new sophisticated types of financial instruments to the market. They are also better suited to the globalisation of financial transactions through their global network of branches and subsidiaries, and through their closer association with other financial firms. Some Japanese securities firms are prominent among the group of strong firms in this sense, and these are quickly internationalising their business and contributing to the vigorous international activity of Japanese investors.

3) Liberalisation of Government Regulations

The first step towards liberalising investments in foreign financial securities by residents was taken in 1970, when small portions of mutual funds (investment trust funds) were permitted to be invested into foreign securities. In subsequent years foreign exchange controls were gradually relaxed as the trade balance showed a growing surplus. But substantial liberalisation did not take place until the overall revision of the exchange control system in December 1980, under which all foreign exchange transactions, with some minor exceptions, became free, and the system of requiring approval for each investment in foreign securities was abolished.

Nevertheless, there remained many government regulations which seriously affected the freedom of capital movements into and out of Japan. Since November 1983, a series of bilateral talks have taken place between representatives of Japan and the United States, frequently referred to as the 'Yen/Dollar Committee', in order to expedite the liberalisation of Japanese money and capital markets and to internationalise the yen. Agreements on various financial matters have been reached and substantial liberalisation has been introduced since May 1984, especially in the field of international capital transactions. This change has had a most significant effect upon the

outward flow of capital from Japan, as shown in Tables 5 and 6.

The Yen/Dollar Committee meets periodically, and participants are working on the further liberalisation of the market. The relaxation of the remaining regulations is now being implemented quite rapidly, partly because an increase in capital outflow helps to slow the appreciation of the yen.

4) Improvement in the Global Service Network

Another factor which has contributed to increasing the capital outflow from Japan in recent years is an improvement in the service network related to the international capital transactions, reflected in an increase in the number of banks and securities firms from foreign countries operating in Japan and vice versa. Japanese investors are now enjoying easier access to more profitable investment opportunities through an expanded service network operated by both domestic and foreign financial institutions.

On July 1, 1986 the total number of Japanese securities firms' establishments in foreign countries was 150 (27 in the USA, 22 in London, and 17 in Hong Kong), of which 70 were in the form of subsidiaries in which they had a capital share of 25% or more (10 in the USA, 14 in London, and 13 in Hong Kong), 19 were branch offices (13 in the USA) and 61 were representative offices (4 in the USA, 8 in London, and 4 in Hong Kong). In the twelve months prior to that date, the total number of these establishments had increased from 120 to 150, and the number of their parent companies in Japan also increased from the 14 largest securities firms to 26.

The total number of foreign securities firms working in Japan on the same date of 1 July, 1986 was coincidently also 150, out of which 21 were from the USA, 41 from the United Kingdom, and 20 from Hong Kong. There were 26 branch offices, and the rest were representative offices responsible for liaison between Japan and their head offices. Six offices have already obtained membership of the Tokyo Stock Exchange.

At the end of June 1986, 26 Japanese banks operated 196 overseas branch offices, 21 banks had 74 overseas subsidiaries and the total number of the representative offices overseas was 353. 77 foreign banks operated 113 branch offices in Japan, nine subsidiaries have been incorporated to engage in the trust bank business and there are 124 representative offices. Foreign banks entered Japan much earlier than securities firms, but it was only in the last year that they started trust banking business in Japan.

The fact that government regulation of international capital flows has been relaxed and thus that the capital transactions into and out of Japan have been increasing very rapidly in the past few years, must have caused a sharp rise in the number of financial institutions managing money and capital in Japan or for Japanese investors overseas. This, in turn, must have

contributed through better information and services to increasing the capital outflow from Japan.

C. Motivations for Capital Outflow

1. Aiming at Better Yields

a) Interest Rate Differentials

The prime motive of international investment is, of course, to seek higher yields anywhere in the world, and the simplest approach is to pursue higher interest rates. However, higher interest rates are often accompanied by higher risks. At the beginning of the massive capital outflow from Japan, the interest rate differential between Japanese national bonds and US Treasury notes was the most attractive motive for Japanese investors, who bought mostly fixed interest US Treasury bonds and notes, which carried no creditworthiness or marketability risk.

The more capital that moved out of Japan to earn a higher yield in US dollar bonds, the greater was the impact on the foreign exchange market. Despite the growing trade surplus, the foreign exchange rate moved in favour of the dollar. The Japanese authorities were frequently suspected of intervening indirectly in the exchange market to lower the value of the yen by keeping interest rates low in Japan.

Until the spring of last year, the Japanese authorities seemed to have expected that when the interest rate differential became smaller than three per cent, investments into foreign securities would be discouraged and the yen rate against the dollar would become stronger. However, this expectation was not correct, and capital continued flowing out of Japan even after the interest rate differential became less than three per cent.

It may be appropriate to mention here that some investors have a special interest in a high interest rate coupon or in a high future interest income, rather than in low income gain with high capital gain. There is a preference for stable income from fixed income bearing financial assets. This type of investor includes, among others, the life insurance companies. Another group of investors is paying special attention to the tax treatment on the income from financial assets. Particularly when there is a difference in the rate of tax withheld on interest, this difference may have more influence on the investors' decisions than the interest rate differentials themselves.

b) Foreign Exchange Gains and Capital Gains

From the time when large capital outflow began, until around February 1985, the value of the yen stayed weak against the dollar and there was widespread anticipation that the dollar would appreciate further because of the capital outflow from Japan. Thus many investors were calculating that, even if the interest rate on dollar assets became lower,

possible exchange gains would contribute to the total yield of the dollar bond investments.

After the yen started rising in May 1985, possible exchange losses were a matter of serious concern for every investor who carefully calculated the total income, as expressed in the yen, up to the redemption dates. Investments were made in those dollar bonds only when total income was assessed to be better. As a matter of fact, most investors thought that the possible exchange risks were smaller than the interest rate differentials and investments in dollar bonds were not much discouraged.

The major European currencies were not so severely devalued against the yen as was the US dollar. In the early stages, foreign bonds purchased by Japanese investors were mostly dollar bonds. But the relative strength of European currencies made European bonds more and more attractive, and Japanese investments became more diversified among the currency denominations. Bonds in Canadian dollars and Australian dollars were also examined as possible investments. But they did not become popular as the exchange risks involved were difficult to calculate and there was some uncertainty about their future liquidity.

In the last quarter of 1985, after the Plaza Hotel Agreement, the tempo of the appreciation of the yen became faster and the level of the yen rose much higher than had been anticipated by most Japanese investors. However, this coincided with the decline of interest rates all over the world. This trend was clearest in the United States. The decline of the interest rates caused, of course, a rise in bond prices, and the possibility of capital gains became once more a popular factor in the calculation of total income from bond investments. Some investors actively borrowed dollars and bought dollar bonds, a transaction which was called 'dollar-dollar investment' as compared with the normal yen investment into dollar bonds.

Against this background, Japanese financial institutions of all types increased their purchases of foreign securities, as shown in Table 9.

The behaviour of Japanese investors was at first explained by interest rate differentials between Japan and the United States. Subsequent changes in exchange rates and interest rates contributed to an alteration of the tempo of capital outflow from time to time. But the basic trend of massive capital outflow from Japan has been maintained.

The depth of markets is another important factor in the behaviour of large Japanese investors. As the total assets of the large Japanese institutional investors grow, they are now dealing with a huge amount of money. It is no longer rare to see transaction lots of more than Y100 billion (about $650 million) in the Tokyo market. The share of these large transactions is now rising.

There are only a few markets in the world which can meet the needs of

Table 9

Securities held by Financial Institutions
(¥ billion)

	Total Securities			Foreign Securities		
	Dec. 1983	Dec. 1984	Dec. 1985	Dec. 1983	Dec. 1984	Dec. 1985
City Banks	19,168	20,562	23,554	1,318	1,891	2,803
Regional Banks	17,485	18,547	20,158	541	877	1,837
Trust Banks (Banking Accounts)	5,528	6,578	8,124	298	783	1,304
Long-term Credit Banks	6,960	7,752	8,748	565	863	1,383
Trust Banks (Trust Accounts)	14,716	19,747	24,766	944	1,436	3,461
Investment Trusts	11,920	15,753	17,453	239	843	1,635
Mutual Loan and Savings Banks	5,315	5,396	6,038	112	166	548
Credit Associations (a)	10,130	10,543	11,100	403	534	762
C.C.B.A. (b)	15,481	17,414	19,371	478	603	1,258
Credit Cooperatives	1,186	1,270	1,326	94	107	115
Labor Credit Associations (c)	1,700	1,808	2,037	128	191	333
Life Insurance Companies	13,166	15,442	18,078	2,928	3,842	4,772
Non-life Insurance Companies	4,164	4,777	5,278	571	820	1,022
Postal Life Insurance and Postal Annuities	10,625	12,204	14,098	194	559	946
Total	137,544	157,794	180,029	8,811	13,515	22,182

(a) Including National Federation of Credit Associations.
(b) Central Cooperation Bank for Agriculture & Forestry and National Federation of Agricultural Cooperatives.
(c) Including National Federation of Labor Credit Associations.

Source: The Bank of Japan, "Economic Statistics Monthly".

such large sellers or buyers in terms of liquidity. Only three markets may be well qualified: the Tokyo national bond market, the US Treasury bond market, and some bond futures markets. However, trading in the bond futures markets involves greater risks than the other two and some investors who are managing pension funds or other similar types of funds, like the trust banks and the life insurance companies, do not like to take risks. In their trading of very large lots, the bond markets in Tokyo and New York thus become the only markets deep enough for their major operations.

c) Equity Investment

Up to the present, Japanese on investors have not shown much interest in equities. However, as yields on equities in the long run in most countries are somewhat higher than yields on bonds, some Japanese institutional investors are now reconsidering their portfolio strategies.

2. Seeking Solutions to Trade-Related Problems

Another important cause of the recent large scale capital outflow from Japan is the efforts by many Japanese firms, especially among manufacturing industries, which are seeking solutions to the problems emerging as a result of trade frictions or the appreciation of the yen. In order to avoid trade frictions, Japan needs to make some adjustments in her industrial structure. But this task has already led to many difficult domestic, social and political problems, and it will be difficult to make rapid progress within a short period. The government will take further policy measures to expedite the process of restructuring, but it has to persuade rather than force private business.

Private business is already well aware of the problem it now faces. The dearer yen has already caused a decline in exports (not yet clear in dollar terms but very clear in yen terms and in terms of volume) and it is now undermining their competitiveness with foreign products (especially products of the newly industrialised countries). They have started or are planning to seek more favourable conditions for continuing production and maintaining their technological superiority by moving their production bases overseas. There, they may be able to benefit from more favourable exchange rates, lower priced labour, better access to raw materials and, possibly, favourable tax treatment. Table 10 shows the increase in overseas direct investment by industry between 1975 and 1985.

For instance, with respect to labour costs, the hourly wage in the major industries in Japan becomes higher than that in the United States when the yen rate is higher than Y160 to $1. The hourly wage in Japan is already several times as high as in the neighbouring East-Asian NIC's, where the quality of labour is believed to be as good as in Japan.

This means that those businesses which are planning to move their

production bases abroad are not necessarily limited to Japanese exporters. Even when production is for domestic consumption only, for example textiles and some electric appliances for family use, Japanese producers need to maintain competitiveness with NIC products in the home market. They too may have to move their production bases abroad.

Another technique of direct investment is a merger with, or acquisition of, existing businesses in foreign countries. This, up to now, has been extremely rare. But it is now seen by Japanese businessmen as a possible strategy to cope with import restrictions by foreign countries and the (forced but) voluntary export controls. Some Japanese banks have employed this technique for the rapid development of their global strategy and have already invested heavily in this way.

Table 10

Outstanding Overseas Direct Investment by Industry*
(US $ million)

	March 1976	December 1985	December 1985 / March 1976
Manufacturing	5,164	23,819	(4.6)
Foodstuffs	289	1,078	(3.7)
Textiles	1,016	2,079	(2.0)
Lumber and Pulp	512	1,113	(2.2)
Chemicals	887	3,943	(4.4)
Iron and Non Ferrous Metals	782	5,152	(6.6)
General Machinery	405	1,914	(4.7)
Electrical/Electronic Machinery	522	3,615	(6.9)
Transport Machinery	363	3,140	(8.7)
Others	388	1,785	(4.6)
Non Manufacturing	10,778	53,596	(5.0)
Agriculture and Forestry	215	777	(3.6)
Fishery	130	436	(3.4)
Mining	4,131	11,593	(2.8)
Construction	116	766	(6.6)
Commerce	2,222	12,236	(5.5)
Finance and Insurance	1,307	9,705	(7.4)
Service	2,657	4,463	(6.8)
Transportation		5,591	
Real Estate		2,244	
Others		5,785	
Total	15,943	77,415	(4.9)

* Accumulated Licensed Overseas Direct Investment.

Source: Ministry of Finance, "Licensed Overseas Direct Investments".

D. Impact of Yen Appreciation

As explained above, the rapid appreciation of the yen has impacted seriously upon various aspects of the Japanese economy. Capital outflow to foreign countries will also be affected, principally in two ways.

The first relates to the probable change in the savings patterns among sectors in Japan.

(1) In the corporate sector, the concern about export markets caused by the rapid appreciation of the yen discourages investment in fixed assets. Stable prices induced by the strong yen makes a high level of inventories unprofitable. Thus investment by the corporate sector is declining. However, as the profit squeeze is now spreading, especially among the export-related manufacturing industries, savings by the corporate sector are also shrinking very rapidly.

(2) In the public sector, the shortfall of revenue due to the lower rate of the economic growth, especially given the extremely small rate of growth of nominal GNP attributable to the negligible rate of inflation, and the need for additional budgetary spending to stimulate the economy, will result in higher deficits in the public sector.

(3) Even though savings in the household sector will remain high, the rate of savings may decline as the nominal income of wage earners will not rise much. The aggregate increase in the saving of the household sector will not be large enough to finance the increasing deficits in the corporate and the public sectors.

These probable changes will decrease the excessive savings in Japan as a whole and will reduce the scope for the export of capital.

The second relates to the type of capital outflow from Japan. As a result of the rapid appreciation of the yen, there are many businesses, especially among the export-related industries, which are seriously reviewing their medium term strategy and weighing the merit of direct investment abroad. If the value of the yen is to remain unchanged at a high level, they may give up their plans of expanding their plants in Japan and prefer to invest in foreign countries. As long as there remains a feeling that the yen has not yet reached its peak in the exchange markets, there will be widespread anxiety about future export markets, and the trend toward overseas direct investments will be accelerated.

Another change in the form of capital outflow, caused by the dearer yen, is found in the active moves of Japanese firms to acquire foreign businesses. Recently one of the big Japanese chemical companies spent several hundred million dollars to acquire a portion of an American company, and some banks bought American and Hong Kong banks as part of their global operations. This 'merger and acquisition' phenomenon,

which is now costing much less because of the strong yen, will continue and will probably increase.

There are also an increasing number of cases of investments in real estate in foreign countries, especially in big cities like New York, London and Los Angeles. Some of these properties were bought for the use, now or in the future, of the Japanese investors themselves. But some others may have been purchased with a speculative purpose, spurred by the fact that Japanese real estate prices have skyrocketed in the past year. Rates of return on those costly properties in Japan appear to be much lower than those on investments abroad. This activity also has increased as a result of the appreciating yen, which has made those investments much cheaper than, for instance, a year ago. There is no reason to believe that this activity will cease, unless there is a sudden and sharp depreciation of the yen.

It is always very difficult to foresee the movement of exchange rates, or to foresee future movements of capital. However, since it is hard to anticipate any major changes within a short period in the underlying conditions favouring capital outflows from Japan, it would be reasonable to expect large amounts of capital to continue to flow out of Japan for the coming year at least. For the future, the flow may change in response to changes in the exchange rate, in interest rate differentials, in the strength of domestic demand and in all the other conditions governing the outflow of capital.

IV. Concluding Remarks

Though the volume of Japan's exports has already started declining, the trade balance continues to show a large surplus. The tempo of capital outflow from Japan remains very high. There is no clear-cut indication as to when the adverse J-curve effects of the dearer yen (or cheaper dollar) will work themselves out so that the international trade balance will start moving toward equilibrium.

The Japanese Government has already decided that it will adopt various policy measures to stimulate domestic demand and to lessen export pressures. The Eight Point Program which was announced by the Japanese Government on September 19 is designed to give a fiscal stimulus to domestic demand of more than Y3.6 trillion (more than $23 billion). This stimulus is expected to increase domestic demand by more than one per cent of GNP within the current fiscal year. In free market economies like Japan, however, the Government is able to influence the market through appropriate policy measures but it cannot control markets. For the coming year or two, the tempo of decline in the trade surplus may be relatively slow.

It will be some time before the medium term strategies of industrial reconstruction in Japan, which were listed in the Maekawa Report, are reflected in Japan's trade surplus and capital outflow. In addition, there is a question as to whether a similar type of industrial restructuring for the purpose of managing the huge trade imbalance is also needed for Japan's major trading partners, especially the United States.

Meanwhile, the process of de-industrialisation in Japan will continue, and some portion of Japan's industries may be exported abroad or even eliminated from Japan. Every effort will be focussed on advanced industrial products, and on maintaining, through their high quality, their competitiveness in the global market.

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The Group of Thirty
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London WC2 IEX
(01) 380-5396